Transcript

Better conversations. Better outcomes.

Episode 79 – Tax strategies to optimize your client conversations

Rick Kollauf - The tax law changes of 2017 are many and complex and it's important to understand those changes as well as help advise client navigate their way to make sure they pay least amount of tax possible. Every situation is unique. Don't go around taking the standard advice and doling it out to every client.

Ben Jones - Welcome to Better Conversations, Better Outcomes, presented by BMO Global Asset Management. I'm Ben Jones.

Emily Larsen - And I'm Emily Larson. On this show, we explore of wealth advising from every angle, providing actionable ideas designed to improve outcomes for advisors and their clients.

Disclosure - The views expressed here are those of the participants and not those of BMO Global Asset Management, its affiliates or subsidiaries.

Emily Larsen - April 15th has come and gone. You've made it through the tax season. With new changes to the tax code for 2018, your tax experience this year may have been a bit different. It's been a constant topic of conversation over the last month or so, and your clients certainly have experienced this, too. They may have new questions, concerns, or be looking for your advice on ways to better manage their tax planning in 2019.

Ben Jones - After a year of learning about these new tax rules, we're going to address a lot of questions as we explore new strategies around what has changed and what hasn't changed under this new U.S. tax code. Here's our guest.

Rick Kollauf - My name is Rick Kollauf. I am with BMO Private Bank. My title is director of business advisory and estate planning.

Emily Larsen - Rick sat down with me in BMO's private banking office in Milwaukee, Wisconsin to discuss everything in the new tax rules and more. We started with an overview of some tax terms, beginning with defining an effective tax rate versus a marginal tax rate.

Rick Kollauf - Effective rate is just taking your total income and dividing it by your total tax. So, it's your average tax. The marginal number is what your next dollar of tax will be. So if I'm $100,000 of taxable income, I've gone through several brackets, overall, that average bracket is my effective rate. But whatever my bracket is at $100,000, that next dollar, 100,001, whatever bracket that falls into is in my marginal rate.

Emily Larsen - And while we're doing definitions, do we want to talk about tax deduction versus tax credit?

Rick Kollauf - Sure, so a taxed deduction will reduce your taxable income and the benefit, essentially, is the marginal tax rate you're in. So if I have an itemized deduction that I'm itemizing actually, so let's say a dollar of charitable contributions and I'm in the 20% rate, my benefits for spending $1 on charity is 20% because I'll reduce my tax by 20%. A credit gets you a dollar-for-dollar benefit. If I am able to receive some type of benefit for whatever I'm spending on, or if you just talk about the child tax credit, which went from $1,000 to $2,000, that credit is going to actually offset your tax, dollar-for-dollar.

Ben Jones - Let's cover some of the big changes that happened with the passage of the Tax Cut and Jobs Act.

Rick Kollauf - I kind of think about it in terms of where would clients of advisors see some of the bigger changes? Well, one of the things, and as it was touted, this is a lower tax rate paradigm. Most of the tax brackets have been decreased. The highest rate went from 39.6% to 37%, so depending upon what your tax bracket was in '17, or now in '18. As we look forward to '19, hopefully we understand where we fall. Obviously, everybody facts and circumstances make them different from another, as well as from year-to-year, on a client's profile, a tax profile, they could be different from one year to another. But first understanding where you're going to be is going to help you start to plan what is my effective tax rate?

Emily Larsen - And although proposals were made for fewer tax brackets, they stayed with the seven brackets that existed?

Rick Kollauf - Same number of brackets exist, correct.

Emily Larsen - Got it.

Rick Kollauf - Some of the other taxes that people forget about: the net investment income tax, the affordable health care tax on high wage earners intact. So we'll see some tax payers exceed the 37% rate. But for the most part, when we think about just income, that's what we would think about in terms of tax rate. The interesting thing is that largest decrease in tax actually came in a corporate arena for sub-chapter C corporations. There were previously several tax brackets that went from 15% up to 38%. And then, now, every dollar of corporate income will be taxed at 21%. Quite a significant difference. And because of that significant difference, probably the next thing we should about is what was instituted under Internal Revenue Code Section 199(a), the qualified business income deduction for pass-through business owners -- so that could be an LLC, a sole-proprietorship, an S corporation, and such. These types of business owners could see an income tax deduction up to 20% of their qualified business income. There are many limitations and several restrictions on how that operates. For instance, what the IRS calls or what the government calls specified service businesses. For instance, accountants, attorneys, doctors, brokers. These seem to be professions that they did not want to give the 20% deduction to. They may not receive that. Unless they have an income that is below a certain threshold, they'll still get the deduction. But once it reaches a certain threshold, they'll get no deduction. There's a small area between the minimum income threshold and the maximum income threshold, where you might receive a partial deduction, depending upon the amount of wages you received or the amount of property that you put in place.

Emily Larsen - And so, in your experience, this is something that can be anticipated, in terms of who can receive this benefit and how to maximize it?

Rick Kollauf - Yeah, I think this is something that you need to help tax payers, help clients identify: will your business be eligible; is your income threshold at a point that you can receive eligibility, even if you're one of the specified service businesses? Going back one step, the reason this qualified business income deduction kind of made its way into the new tax law is because many people in Congress saw that the sub-chapter C corporations were receiving this large dip in tax rates. But the individuals, while they were receiving lower tax rates, not as great. So there was this impetus, specifically -- actually by Ron Johnson, one of our representatives from Wisconsin -- to make that play into the new tax law. And if we can help focus people on identifying their eligibility, but then also understanding that -- let's talk about clients who are starting a business. Is this going to be impactful enough as qualified business income deduction to help navigate them to a pass-through entity status? Or, might they still want to be a C corporation because, look, 21% is still less. But you have to look over the long-term. Many advisors like to focus, or sometimes do focus on the short-term. Here, we know these rates. We know what the impact is here. But if we think about it longer-term, a client who owns a business, at some point, they're going to exit the business. Whether it's by sale or death, 100% business owners exit their business. So how does that work then? Is there an asset transfer? Is there a stock transfer? Most businesses get sold or transferred by asset transfer, so that could generate a second layer of tax. One, the asset sale at the corporate level if you're a C corporation. And then, when you distribute the assets out to the individual owner, a second layer of tax on that dividend. So, that double layer of tax could nullify the benefit of going to a C corporation. That's a very general scenario. There are other scenarios that you might look at, where it still could be beneficial. So it's one of those crunch the numbers, run the numbers scenarios with your tax professional.

Emily Larsen - And so we spent a little bit of time talking about the impact of business owners from these 2018 tax changes. Can we talk about some of the changes that affected individuals?

Rick Kollauf - Right. Continuing on to the major changes, with the rates coming down, there's a little bit of yin and yang going on here in the new tax law. Standard deductions were doubled, so you also lose the personal exemption. So, you may not have the ability to deduct or itemize anymore, depending upon where you were. For a married, filing joint couple, the threshold was about $12,000 to itemize. Now it's up to 24,000.

Emily Larsen - And so should I just be having thoughtful conversations with our clients about how to get themselves in a place where they can itemize? Is that part of the planning conversation?

Rick Kollauf - Again, it depends on the scenario. Really planning should always focus on two years anyway, not just the year you're in, because, ultimately, what you do this year will impact the next year. If you're talking about bringing income into this year because you're in a lower tax bracket, for instance, through a Roth conversion, or increase your itemized deductions to get the itemize availability, that may mean next year you may not itemize. Next year, you may have less income. So understanding what your effective rate is this year and next year will help you optimize your lowest tax amount between years. That's one of the larger changes as well. You'll see that folks with children are going to see a larger benefit, even though they may not be able to itemize anymore, because the child tax credit went up. There was also an additional other dependent credit added that a $500 per person that was not in the law before. From an itemized deduction standpoint, not only was the standard deduction doubled, but some other things that make it harder for people to itemize now; and that was that the state and local tax deduction is limited to $10,000 in total. Meaning, income taxes by estate, property taxes by estate. You need to add those up and you'll get no more benefit than $10,000. The mortgage interest was modified for mortgages put in place after, I think, December 15th of 2017. We used to be able to take a mortgage interest deduction on properties, as long as the mortgage was $1M or less. That number has now changed to $750,000. We used to be able to take an additional home equity interest deduction. Essentially, home equity interest deductions have gone away. But we really need to look at what is a home equity interest deduction because we used to just classify it by loan type. It's not by loan type. What a mortgage interest deduction is anything that you borrow to buy a home, build a home, or substantially improve a home. Many times, we take out home equity loans to do those things. So as long as we're doing those things, that interest will still be deductible. Again, subject to $750,000 limit now going forward.

Emily Larsen - Many people are used to a certain tax experience every year, whether it's receiving a refund or paying a certain amount. I asked Rick what he recommends for those who want to keep the same tax experience, now that some of the rules have changed. Then, we talked about conversations advisors should be having with their clients to manage 2019 taxes better.

Rick Kollauf - My tip is for tax payers not give the government interest-free loans. So part of what I used to do as a tax professional is counsel people on how to not have refunds at the end of the year. I find most people would rather have the money throughout the year, and getting their refund at the end of the year just means you did give the government an interest-free loan, because they don't give you interest on the refund. So that said, if that's the choice, if you go along with that philosophy, what you should be doing is projecting your income and expenses annually to determine where you think you’re going to be. Are you going to owe money, or are you going to have to pay money? Depending on if you're going to owe or pay, you can adjust your withholding at work through your W-4. And then, depending upon how many changes or exemptions you can claim to either increase your withholding, which means reduce your refund, or decrease your withholding to increase your refund is how you would approach that. That can be done -- tax payers can actually find those programs online. IRS.gov has a program that can help you do that. But if your situation is complex in any way whatsoever, again, I'm going to refer you to some type of tax professional. Especially to get the appropriate tax-planning software to, first, figure out if you expect a refund or don't. For those that do want that refund, it's the same process.

Emily Larsen - On that topic, what are the conversations that advisors should be having to help their clients become more tax aware and manage 2019 better?

Rick Kollauf - So as we mentioned earlier, I think the qualified business income deduction is probably one of the more important changes. Because it's new, it also has a lot of vague, black hole, undefined, unfortunate pitfalls in the legislation. There have been some regulations issued. I know that there is talk even about more changes -- excuse me, not necessarily changes, but technical corrections. As an advisor, you should be thinking about, again: is my client a business owner; do they qualify for this deduction; is their choice of entity status the most appropriate; do we need to engage a tax professional to collaborate with, to help determine how do optimize and get to the lowest level of tax on a go-forward basis; and, when all is said and done, are there things I can do yet to continue to manage that tax? So let's say it may be beneficial to remain a C corporation or to change a C corporation status. Should the business owner them pay themselves less of the salary and pay out more in dividends, and get the rate at 20%? It used to be we used to always have business owners zero out their corporate income through salary. But now, with the differential in rates, maybe it's not the case. We always have to remember, too, are we getting reasonable compensation because the IRS doesn't like it when we don't. And if you are going to retain that pass-through entity status to take access of the qualified business income deduction, or for whatever reason that's the best situation for you, do we need to manage a tax payer's overall income? So that, possibly if they're in a specified service business that they wouldn't get the deduction for, maybe we can get them to a lower threshold that we can actually qualify for the deduction? So those are the types of navigation that an advisor should be assisting with. And if they don't have the tax chops, there's nothing wrong with collaborating with a tax professional. And aside from the qualified business income deduction, I would tell advisors -- I'll just list off a handful of other things that I think are most important and that they'll see the most in their practice. Look at a client's loans. Are they tax-effective? Do they expect that the after tax rate of return on their investments will exceed their after tax benefit from the deduction, if they're even getting the deduction at all? Because if not, maybe it's time to pay those loans off, right? In addition, charitable deductions. Even for people that aren't able to itemize this year, if we were to look at a client that was close to being able to itemize and we looked at their charitable contribution profile, maybe they could lump those charitable contributions into one year. And in doing so, maybe itemize this year. Maybe you're not itemizing in years two and three, but you weren't going to be able to anyway. So, you're still is getting the benefit of the higher standard deduction. Clients sometimes say, well, I want to make sure that whomever my charitable donee is, whether it's my church or whatever, they want to see we give every year. Well, for those clients, we can think about setting up what's called a donor-advised fund. Essentially, it's an account that you would establish that would allow you to get a deduction this year by taking those several years of contributions, putting it into this account. And then, you would then advise on every year how much to give. That allows you to get full benefit this year, but then dole it out over the next few years. The estate planning that we talked about, I think, is important as well for wealthy clients. Again, understanding that there's more to give away. Some regulations have been issued that say that the IRS will not claw back this larger amount that you can give away tax-free now. What do I mean by that? So let's say I'm an individual and my lifetime exemption is $11.4M this year. What if I'm counseled by someone -- and I have a larger net worth, let's say it's $20M. And so I'm looking at maybe giving away a chunk this year, and let's say it's that $11.4M. What happens in 2026, when some of these laws sunset and we go back to that $5M+, if I were to then die, would I have to pay the estate tax based on the then $5M deduction. And the regulation is saying no. We get that $11.4M today, and when we die we'll factor in that we were allowed that amount. So maybe we need to look at our more wealthy clients and determine if we're thinking about advising them on gifting, especially those larger gifts, because think about it: when we give those larger gifts, we're not only reducing our taxable estate today, but we're taking future appreciation out that could be cumbersome and add to our estate tax later on. So now before, 2026, if we do go back after that sunset to that lower lifetime exemption, we should be helping them understand that now is better than never. And just a few other things. Not necessarily part of the tax law change in '17, but we all know that there are indexes put in place for dollar amounts to rise. So the 401(k) limit went up $19,000 in 2019. The IRA, when it went up to $6,000 and the health savings account limit went up to $7,000 per family. We want to make sure the clients eligible for those deductions are maximizing if they can, depending on their cash flow needs. And as an advisor, that only benefits our practice as well because it adds to what we're advising on.

Ben Jones - Rick provided us several great conversations to engage your clients with, and you can start today. First, do they want to adjust their withholdings, or have they adjusted their withholdings to make their tax experience work the way they would like at the end of the year. Second, is their use of leverage tax efficient? If not, it might be time to pay down or pay off some of those loans. And third, do they make contributions consistently to a charity that they could pool together and lump into one year so that they can do an itemized return versus two years of standard deductions? Or should they be exploring the use of a donor-advised fund, or a DAF? Now one question that we hear often is which state is the most beneficial home state, or place to claim your primary residence and pay taxes in. Rick gives us some great tips on that and then talks about what the future holds for other potential tax rule changes or modifications.

Rick Kollauf - And we do a lot of advising on domicile, domicile being where is your home state to pay tax. Very generally, high level view is my opinion; the tax tail should not wag the dog. It's going to be important consideration. Clients usually think it's their top of mind consideration, but there are so many factors that are different among states. It's not just the income tax. What about sales tax? What about property tax? What about lifestyle cost? My cost to buy a home in California is much more than it is to buy a home in Wisconsin. What about insurance? If I'm going to move to a hurricane state like Florida, my home insurance might triple. I mean, you ahead to look at all these factors, and these are cost factors, and then there are other factors that don't involve costs. What is my quality of life going to be? Maybe as I get older I want to be in a warmer climate, but maybe all my children are in Maryland, so do I want to be in Arizona and travel back and forth to Maryland, or do I want to be in Maryland and be close to my family and children, my grandchildren? So those are all the things that I think it's important to help counsel people on, but what I find why clients come to us or why an advisor wants to talk to a client. One, again I think there still is the tax talk button, right? And maybe because of the loss or limitation on the state tax deduction at the federal level to the maximum of 10,000 and the fact that there are these high-tax states such as California, New York, Illinois. Clients are thinking about it, so maybe you want to start talking to them about it, but make sure you look at it holistically so you don't give bad advice. Clients that have those retirement years coming are usually, again, another group of folks that are thinking about should I move? You know, if I'm retiring in Wisconsin or Illinois, and even if it's not a tax issue, maybe it's that warm climate issue, the Sunshine State, you just see a lot of it. But again, help them understand, you know, where is the biggest benefit. One thing that's interesting to note is if I'm working with a business owner that is thinking about exiting the business or retiring, if you will, typically they're going to own stock, and if we can arrange for their sale of the business to be more like a stock transaction, it may very well be that if they're already thinking about re-domiciling after, they may want to think about re-domiciling before the sale because in doing so, they'll move to a state before closing on that deal, and if they do, they could actually avoid the tax on the sale of the business. They may not avoid the tax, you know, on the ongoing income from the business because you pay tax in the state where you have nexus. If I own a business in Wisconsin and I live in Florida, I'm going to get a K-1 from that business, let's say in Wisconsin, to pay non-resident tax in Wisconsin, but if I move before I sell the business, that capital gain is what's called an intangible income. The intangible income follows wherever your domicile is, so I will look at where I'm domiciled at that time. If I'm a Florida resident, I don't necessarily have to pay Wisconsin tax, so that's kind of something we've counseled several clients who have sold some large businesses on. I've seen people actually fly down to Florida before they close their deal, buying a condo with the savings and think this is the greatest thing since sliced bread. So those are the -- I hope that answers your questions on, you know, whether advisor should be talking to their clients about -- if they're thinking about moving states.

Emily Larsen - Yeah, that's great. Absolutely. Do you see more changes coming for advisors that they need to be aware of or should be discussing with their clients as part of the tax conversation?

Rick Kollauf - This is interesting, and I think everyone needs to stay on top of legislative activity, but you also need to understand the political climate, and so when we had the changes in 2017, understand we had Republican House, Senate, and President. It was easier to do to make those changes. It still wasn't all that easy because we had a close split, but look at where we are now. We have a divided Congress. We have a Democratic House, a Republican Senate. We have a Republican President. For anything to get passed through Congress with the bipartisan games that are being played now, I would see almost nothing happening. That being said, there is a limited about of bipartisan legislation taking place. Some of it revolves around technical corrections. Whether you're a Democrat, a Republican, an independent or whatever, you want the legislation that was written to be understandable, manageable, and not have either loopholes or not have gaps where people can't file their tax returns right, and the IRS can't manage what it does from a collection standpoint. So technical corrections usually are bipartisan. If a technical correction is part of a more controversial piece of legislation -- for instance, you talked about the Affordable Care Act -- there's some technical corrections that are being proposed even today, as long ago as that was put in place. The problem is that original legislation is so controversial, even the technical corrections have a hard time passing. So there are some technical corrections out there. One I can think of offhand relates to some of the capital expensing that was put in place, the bonus depreciation and Section 179 limits that were increased. There were some qualified properties that were allowed to have 15-year life, so think retail, think interior of buildings. As long as you had that 15-year life, you were able to qualify for bonus depreciation, which is 100% expensing, or Section 179, which is just different limits of expensing. That's a technical correction I see maybe with some others passing. There is also some bipartisan legislation related to retirement plans, so this should be of key interest to advisors. Two things that come to mind in this retirement legislation. One would allow annuities in 401(k)s, which we can't have now, so that could be something, depending upon if part of your practice delves into annuities. If it doesn't, you may see insurance providers trying to take some of your business away, as well as multi-employer plans. For large employers, multi-employer plans are fairly easy to get into and administer, but for a lot of small employers that would benefit from multi-employer plans, they find it hard to make that happen, and the bipartisan legislation would allow for that.

Emily Larsen - And for more on RESA check out our episode 71 with Congressman Kelly. Thanks so much to Rick for coming on the show today and sharing his vast knowledge on this topic. We'll end with what Rick describes as the feeling an advisor should get when they get the tax conversation right with clients.

Rick Kollauf - Well, from an advisor standpoint, I mean, you glow. I mean, you really -- you feel like you've been their champion. You've helped them. To me, that's what I do in our practice is from an advisory standpoint, when I'm counseling clients and you immediately see their eyes light up and, you know, they start thanking you, and you just feel good. Helping people is what it's all about, so if an advisor gets it right, then they should feel that glow.

Emily Larsen - And how does it feel to be the client in that situation?

Rick Kollauf - Well, the client feels appreciated. They feel taken care of. The relationship immediately, you know, broadens, expands, deepens because they think of you as a trusted advisor. You know, hopefully you're trying to get to be the most trusted advisor, but getting a seat at the table and getting that place card is going to get you there, so if you're able to provide that advice, the client is going to get you there.

Ben Jones - Thank you for listening to *Better Conversations. Better Outcomes.* This podcast is presented by BMO Global Asset Management. To access the resources discussed in today's show, please visit us at www.bmogam.com/betterconversations.

Emily Larsen - We love feedback, and would love to hear what you thought about today's episode. You can send an e-mail to betterconversations@bmo.com.

Ben Jones - And we really respond.

Emily Larsen - We do.

Ben Jones - If you thought of someone during today's episode, we would be flattered if you'd take a moment and share this podcast with them. You can listen and subscribe to our show on Apple Podcasts, or whatever your favorite podcast provider is. And, of course, we would very greatly appreciate if you'd take a moment to rate or review us on that app. This show and resources are supported by a very talented team of dedicated professionals at BMO, including Pat Bordak, Gayle Gipson, Matt Perry, Derek Devereaux. The show is edited and produced by Jonah Geil-Neufeld and Annie Fassler of Puddle Creative. And these are the real people that make this show happen, so thank you. Until next time, I'm Ben Jones.

Emily Larsen - And I'm Emily Larson. From all of us at BMO Global Asset Management hoping you have a productive and wonderful week.